No. 6835

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN FREULER, ADMINISTRATOR OF THE ESTATE OF LOUISE P. V. WHITCOMB, DECEASED, RESPONDENT

ON PETITION TO REVIEW THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR PETITIONER

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INDEX

CITATIONS

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PREVIOUS OPINION

The only previous opinion in the present case is that of the Board of Tax Appeals (R. 42–53), which is reported in 22 B. T. A. 118.

JURISDICTION

This appeal involves income tax for the period from January 1 to June 14, 1921, in the amount of $723.60 (R. 9) and is taken from a decision of the Board of Tax Appeals entered June 25, 1931 (R. 54). The case is brought to this Court by petition for review filed December 22, 1931 (R. 55–60), pursuant to the provisions of Sections 1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109–110.

There are two other causes pending upon petitions for review, Nos. 6833 and 6834, upon the docket of this Court, which pertain to deficiencies in income tax for the calendar years 1922 to 1925, inclusive, and for the period from June 14 to December 31, 1921, respectively, but by stipulation of counsel and with the consent of the Court the records in Nos. 6833 and 6834 have not been printed and the Court is asked to dispose of these cases in the same manner as No. 6835.

QUESTION PRESENTED

Where a life beneficiary of a trust receives her full share of the accruing income, undiminished on account of any depreciation reserve, which income is properly taxable to her when received, may the taxable status of said income be retroactively changed by an order entered in a friendly settlement of the trustee's account before a state court some years later, in pursuance of which a small unidentified portion of the said income is repaid to the trustee?

STATUTES INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227:

> SEC. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—
>
> * * * * *
>
> (4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected

by a guardian of an infant to be held or distributed as the court may direct.

* * * * *

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

Revenue Act of 1924, c. 234, 43 Stat. 253:

SEC. 219. (b) Except as otherwise provided in subdivisions (g) and (h), the tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary. The net income of the estate or

trust shall be computed in the same manner and on the same basis as provided in section 212, except that—

* * * * *

(2) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under paragraph (3) in the same or any succeeding taxable year.

Section 219 (b) (2) of the Revenue Act of 1926, c. 27, 44 Stat. 9, reenacts verbatim the corresponding subsection of the Revenue Act of 1924.

STATEMENT OF FACTS

The findings of fact of the Board of Tax Appeals (R. 34–42) may be restated for present purposes as follows:

Louise P. V. Whitcomb was from sometime in 1889 until her death on June 14, 1921, the widow of A. C. Whitcomb, deceased. Charlotte A. W. Lepic is the daughter of the said A. C. Whitcomb, deceased. Marguerite T. Whitcomb, Louise A.

Whitcomb, and Lydia L. Whitcomb are the widow and two children of Adolph Whitcomb, deceased, who was the son of A. C. Whitcomb, deceased.

The said A. C. Whitcomb died in the year 1889, a resident of the State of California, leaving a last will and testament which was duly admitted to probate and record by the Superior Court of the State of California, in and for the City and County of San Francisco. Said last will and testament provided, among other things, as follows:

> 7th. I give to my hereinafter named Executor, Jerome Lincoln, of said San Francisco, all the rest of my property, real, personal or mixed, except what I may have in France, of every kind and nature and not hereinbefore disposed of, after the payment of my debts, in Trust, nevertheless, to pay over to my said wife, Louise Palmyre Vion Whitcomb, one-third part of the interest thereon or income therefrom, for and during her natural life, and the other two-thirds parts to my two children, born of her; one, Adolph, born on or about the 23rd day of February, 1880, and the other, Charlotte Andree, born on or about the 4th day of December, 1882, with the reversion or remainder of the whole three-thirds parts to the descendants "per stirpes" of the said two children, if any be alive at the time of the death of the said two children; and if none be alive at that time, to Harvard College, in conformity with the provisions named or indicated in Section

Six (6) of this Will, having reference to said Harvard College.

The said will contained no directions in regard to the manner in which the income from the trust should be computed, accounts kept, or depreciation provided for.

James Otis was appointed a trustee of said trust on February 23, 1896. He has acted as such trustee continuously since that date, and since the year 1905 he has been the sole trustee of said trust.

The original trust estate consisted largely of cash, bonds, stocks, and notes. On February 23, 1906, the trust estate consisted of bonds, corporate stocks, cash, and promissory notes secured by mortgages, of a total value of more than $3,000,000, and certain parcels of real estate, most of which were in San Francisco. On April 18, 1906, the San Francisco earthquake and fire occurred. All of the improvements on the San Francisco real estate owned by the trust were destroyed by the fire, including those on the large parcel at Eighth and Market Streets, which the trust still owns and on which the Hotel Whitcomb now stands. Some time after the San Francisco fire the trustee of the said trust adopted the policy of improving the real estate owned by the trust and of converting the other assets of the estate to accomplish that purpose. As a result of said policy and of the acquisition of additional parcels of real estate, the assets of the trust for several years prior to 1921, and during

the years 1921 to 1926, inclusive, consisted almost entirely of improved real estate, including the Whitcomb Hotel and its furniture and equipment. The last item represented an investment of more than $2,000,000.

During the years 1921 to 1926, inclusive, the trust estate suffered exhaustion, wear and tear, as follows:

1921	$43,003.16	1924	$39,258.00
1922	39,408.00	1925	39,108.00
1923	39,408.00	1926	55,833.00

The trustee or trustees of said trust made payments of the income from the trust in equal shares to the widow and two children of A. C. Whitcomb, until the death of his son Adolph, which occurred on September 5, 1914. The testator's widow, Louise P. V. Whitcomb, died on June 14, 1921. During the years 1921 to 1926, inclusive, the income from said estate was paid as follows:

1921. ⅓ to Louise P. V. Whitcomb until her death on June 14, 1921, and thereafter ⅛ to her estate;
⅓ to Charlotte A. W. Lepic until June 14, 1921, and thereafter ⅛;
⅓ to the widow and two children of Adolph Whitcomb, namely Marguerite T. Whitcomb, Lydia L. Whitcomb, and Louise A. F. E. Whitcomb, until June 14, 1921, and thereafter ⅛;

1922, 1923, 1924, and 1925. ⅛ to the estate of testator's widow, Louise P. V. Whitcomb;
⅛ to the testator's daughter, Charlotte W. Lepic;
⅛ to the widow and two children of the testator's son, namely Marguerite T. Whitcomb, Lydia L. Whitcomb, and Louise A. F. E. Whitcomb.

1926. ½ to testator's daughter, Charlotte A. W. Lepic;
½ to the widow and two children of the testator's son, namely, Marguerite T. Whitcomb, Lydia L. Whitcomb, and Louise A. F. E. Whitcomb.

144157—32——2

The trustee of said trust filed fiduciary returns for the years 1921 to 1926, inclusive, and deducted in computing the net income of the trust for each year the respective amounts above set forth, representing exhaustion, wear and tear sustained by the trust. The trustee, however, did not withhold from the beneficiaries to whom income payments were being made the amounts represented in the depreciation deduction, and each of said beneficiaries received her ratable share thereof during the years involved herein, as well as in preceding years.

From 1903 to 1928, inclusive, the trustee or trustees of said trust presented an annual account to the beneficiaries entitled to income payments, but did not file any account in the Superior Court of California, which has jurisdiction over the trust until its termination for the settlement of accounts and for other purposes.

On September 5, 1928, James Otis, as trustee of said trust, filed with the Superior Court in San Francisco his account accompanied by a petition for its allowance. The account covered the period from February 23, 1903, to February 23, 1928, and it set out all of the payments made to the beneficiaries of said trust during that period.

The allowance and approval of said account was opposed by Napoleon Charles Louis Lepic and Charlotte de Rochechouart, children of Charlotte A. W. Lepic, one of the beneficiaries herein, who are two of the remaindermen entitled to part of

the corpus of the trust upon the termination thereof, if they be then living. In their objections, which were duly filed with the Superior Court of the State of California, in and for the City and County of San Francisco, they allege that the trust property had sustained depreciation during the years 1913 to 1927, inclusive, in the amount of $622,434.11; that no reserve or other provision for such depreciation had been made from the gross income of the trust estate; that said amount of $622,434.11 had been paid by the trustee to the beneficiaries of the trust entitled to the income therefrom, as income, thus impairing the trust property by that amount, and they prayed that the trustee be charged with that amount. All of the parties interested in said trust estate, including Harvard College, were notified of the filing of said account of said trustee, and of said objections, and were represented by counsel at the hearing held thereon. On September 19, 1928, the Superior Court of the State of California, in and for the City and County of San Francisco, entered two orders, one original and the other an amending order, settling the trustee's account. These orders are set forth in full at pages 136 to 144 of the record. In substance they sustain the objections of the two remaindermen and decree the overpayment of the amounts claimed to have been erroneously distributed as income in the several years from 1913 to 1927. The first order directs the payment by delivery of promissory notes, payable without interest at the

termination of the trust to the remaindermen as then determined. The amended order omits reference to the manner in which the several sums are to be repaid. The orders also direct the trustee to withhold annually from and after February 23, 1927, a proper amount from income on account of depreciation reserve.

On January 17, 1929, Louise A. Whitcomb, Marguerite T. Whitcomb, Lydia L. Whitcomb, Charlotte A. W. Lepic, Napoleon Charles Louise Lepic, and Charlotte de Rochechouart executed and delivered to the said James Otis as trustee of said trust their promissory notes for the amounts by which the distributions made to them exceeded the distribution which would have been made had the trustee retained a reserve for depreciation of the trust property. Charlotte A. W. Lepic, Napoleon Charles Louise Lepic, and Charlotte de Rochechouart executed a joint note. The other notes were separate notes of the individuals concerned. These notes bear no interest and by their terms are payable at the termination of the trust, which will be upon the death of Charlotte A. W. Lepic. A payment of $10,700 has been made to the trust by the Estate of Louise P. V. Whitcomb.

The life beneficiaries, in their returns of income for the years mentioned, did not include the amounts paid to them in those years by the trustee representing their proportionate share of the depreciation sustained and deducted on the fiduciary return of the estate. The petitioner increased the

income shown on the several returns by said proportionate share of said depreciation and determined deficiencies in tax as hereinabove set forth. The Board of Tax Appeals, six members dissenting, reversed and set aside the determination of the Commissioner.

SUMMARY OF ARGUMENT

For nearly forty years the life beneficiaries under a deed of trust created in 1889 received and enjoyed the full income therefrom undiminished by any amounts on account of depreciation reserve, although depreciation was claimed and allowed to the trustee. After adverse decisions of the Board of Tax Appeals and the Court of Appeals of the District of Columbia upon the right of certain life beneficiaries (including respondent's decedent) to deduct depreciation with respect to earlier years, an order directing repayment of the amounts received attributable to the account of the depreciation reserve for the years 1913 to 1927 was entered by a state court in a friendly settlement of the trustees account. The order met with scarcely more than nominal compliance on the part of respondent.

The context and legislative history of Section 219 of the Revenue Act of 1921 and corresponding sections of later statutes clearly indicate that it contemplates two types of distributions to beneficiaries, one of current income distributed under the terms of a self-executing deed of trust, as in the present case, and the other where distribution is made by a guardian under court orders. The dis-

tributions made in the present case were in fact and in law controlled by the original deed of trust executed in 1889.

The mere construction of a will, contract, or other instrument by a state court will not be adopted by a Federal court as conclusive unless it has been settled by the highest court of the state and so long acquiesced in as to constitute a rule of property. Where this situation does not obtain the United States court is in duty bound to exercise its own independent judgment, as it always does when the case before it depends upon the doctrines of commercial law or general jurisprudence. These principles have the support of a line of decisions of the Supreme Court extending from *Swift* v. *Tyson,* 16 Pet. 1, to *Black & White Taxicab Co.* v. *Brown & Yellow Taxicab Co.,* 276 U. S. 518.

The majority opinion of the Board of Tax Appeals in this case is capable of being sustained, if at all, on the sole premise that the orders entered by the probate court in San Francisco retroactively changed the taxable status of income distributed during prior years. We know of no authority which holds that the decision of a state court can divest parties of rights previously accrued under a Federal statute. The practical result of applying such a doctrine in the administration and collection of the Federal revenue would be far-reaching and detrimental, paving the way for grave abuses. It should not and need not be countenanced in the existing state of the law.

ARGUMENT

It is believed that discussion of the question presented by this record may well be prefaced by a brief analysis of the fact situation. The respondent's decedent was one of the life beneficiaries under a deed of trust executed by her husband, A. C. Whitcomb, who died in 1889. (R. 34.) The successive trustees accounted annually until 1902, but no formal account was filed thereafter until 1928. (R. 38, 127.) The trust property consisted initially chiefly of nondepreciables, but later, by a process of gradual conversion, it came to be composed largely of improved real estate subject to depreciation. (R. 35–36.) The trust instrument directed payment of one-third of the life income to respondent's decedent (R. 77), and in pursuance thereof the said one-third was paid undiminished by any amounts on account of depreciation reserve and the other life interests were similarly treated (R. 36–38).

Respondent's decedent, together with two other life beneficiaries under the trust, disputed the determination made by the Commissioner of Internal Revenue for the years 1917 to 1920, inclusive, contending that they were wrongfully taxed in those years in respect of depreciation which had been allowed as a deduction in determining the net income of the trust for the years involved. The Board of Tax Appeals approved the Commissioner's determination, concluding that the distributive shares of the beneficiaries for tax purposes must be computed with due regard for what they

actually received, and that depreciation, which affects only capital assets and not income, may not be deducted by life beneficiaries. *Louise P. V. Whitcomb et al.,* 4 B. T. A. 80. The Board decided another appeal by one of the same parties presenting the same question upon the authority of the foregoing case. *Marguerite T. Whitcomb,* 5 B. T. A. 191. This decision was reviewed and approved by the Court of Appeals of the District of Columbia, the decision being entered April 2, 1928, and reported 25 F. (2d) 528, *sub nomine Whitcomb* v. *Blair.*

The surviving trustee filed fiduciary returns for the years 1921 to 1926, inclusive, deducting in the computation of the net income of the trust in each year an amount representing exhaustion, wear and tear sustained by the trust. He did not withhold from the beneficiaries to whom income payments were being made the amount covered by the depreciation deduction and each of the beneficiaries received his or her ratable share thereof during the above period just as in the preceding years. These amounts were excluded in the income-tax returns filed on behalf of the beneficiaries but added back to income by the Commissioner. (R. 25.) The deficiency was asserted upon March 23, 1926. (R. 7.)

On September 5, 1928, more than two years after the assertion of the deficiency against this respondent, and five months after the decision of the Court of Appeals in *Whitcomb* v. *Blair, supra,* the trustee filed his account for the period February 23, 1903,

to February 23, 1928 (R. 38), and prayed for its approval (R. 110–128). Although the remaindermen, Napoleon Chales Louis Lepic and Charlotte de Rochechouart, were nonresident aliens residing in France, they filed their objections to the account covering the years 1913 to 1927, inclusive, on the second day following. (R. 129–132, 140.) The trustee answered four days later. (R. 133–135.) On September 19, 1928, two weeks after the account was filed, the court entered a decree (R. 136–139) in which it set forth the amount of depreciation of the property of the trust from 1913 to 1927 as determined by the United States Government in connection with the income-tax returns of the trust and held that the remaindermen's objections to the trustee's account were sustained in so far as the trustee had failed to withhold from distribution to the beneficiaries amounts sufficient to offset the depreciation sustained by the trust property. The beneficiaries were required by the court to repay to the trustee the respective amounts received by them referable to the depreciation account during the years 1913 to 1927 "by making, executing, and delivering to said Trustee their respective promissory notes, payable without interest, at the termination of said trust to the order of the remaindermen." (R. 138–139.) An amended order filed upon the same day eliminated reference to the fact that the amounts of depreciation were those determined by the Federal internal revenue authorities, and also

144157—32——3

omitted reference to the notes proposed to be executed. (R. 140–144.) Notes were in fact executed by or on behalf of the several beneficiaries other than respondent's decedent. (R. 145–148.) Although Napoleon Charles Louis Lepic and Charlotte de Rochechouart were remaindermen and not life beneficiaries and hence not in receipt of any income from the trust, they joined in the note of their mother, Countess Charlotte Andree Whitcomb Lepic. (R. 145.) A payment of $10,700 was made to the trustee by the estate of Louise P. V. Whitcomb. (R. 42.) The record does not disclose on what account or with respect to what year or years this payment was made.

With this résumé of the most significant facts we proceed to a consideration of the reasons which, it is believed, require reversal of the decision of the Board of Tax Appeals.

I

The distribution of the income to life beneficiaries, including respondent's decedent, was controlled in fact and in law by the terms of the deed of trust executed in 1889

The deed of trust executed by A. C. Whitcomb in 1889, pursuant to which distribution was made, required the trustee to pay to his wife, the respondent's decedent, "one-third part of the interest" from the property placed in trust "after payment of my [the settlor's] debts." (R. 77.) There was no provision for a depreciation reserve and no authority to the trustee to withhold income on that account or otherwise. Pursuant to the terms of

the instrument payments were made of an undiminished one-third of the net income of the trust until the death of respondent's decedent in 1921, and a lesser fraction to her estate thereafter to and including 1926, no amount being withheld in any year on account of depreciation reserve or otherwise. This situation leads to the question whether the taxing authorities in the administration of the Federal revenue laws are obliged to ignore the actual course of distribution of the trust income consistently followed over a period of almost forty years.

Section 219 (a) of the Revenue Act of 1921 extends the income tax imposed by earlier sections to estates and trusts including—

> (4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

We submit on behalf of the Government that the statute has the effect of placing in juxtaposition two methods pursuant to which income is commonly distributed, one, by virtue of the terms of a self-executing deed of trust as in this case, and the other by force of an order of court required where income is distributed by a guardian to an infant. This view of the statutory provision is strengthened by the succeeding subsections, notably 219 (b), (d), and (e). Thus, in subsection 219 (b) the statute provides for deductions for charitable contribu-

tions such as are set forth in Section 214 (a) (11) of the statute, specifying:

> * * * there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of Section 214.

No reference to "order" is made in this connection, for obviously a guardian of an infant would not be required by court order to distribute income to charities. However, this provision serves to emphasize the fact, really quite an obvious one, that Section 219 (a) (4) contemplates two types of distributions, one of current income pursuant to a trust instrument, the other of income distributable under court orders.

The provisions in each of the later subsections relate back specifically to Section 219 (a) (4). From this it follows that the "order" referred to in subsections (b), (d), and (e) is the order spoken of in subsection (a) (4). Since that "order" relates exclusively to guardians, it follows that Congress intended the trust instrument to control in the case of trusts and the court order in the case of guardians. This separation is brought out in the Revenue Acts of 1924 and 1926, subsection 219 (b) (2) of which provides:

> There shall be allowed as an additional deduction in computing the net income of the

> estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not.

The legislative history demonstrates conclusively that the statutory changes were not the manifestation of a change of legislative purpose, but were intended to clarify the existing law.[1] Clarifying provisions in new legislation have repeatedly been recognized as declaratory of existing law. *Baltzell* v. *Mitchell,* 3 F. (2d) 428 (C. C. A. 1st), certiorari denied, 268 U. S. 690; *Nichols* v. *Leach,* 50 F. (2d) 787, 790 (C. C. A. 1st), affirmed, 285 U. S. 165; *Merle-Smith* v. *Commissioner,* 42 F. (2d) 837, 842 (C. C. A. 2d), certiorari denied, 282 U. S. 897–898; *McCauley* v. *Commissioner,* 44 F. (2d) 919 (C. C. A. 5th); *Dickey* v. *Burnet,* 56 F. (2d) 917 (C. C. A. 8th).

Considered from a practical viewpoint it seems idle to look beyond the written instrument creating the trust inasmuch as distribution was actually

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[1] S. R. No. 398, 68th Cong., 1st Sess., p. 25:

"SEC. 219. This section has been rewritten in order to secure clarity and to prevent the evasion of taxes by means of estates and trusts."

See also H. R. No. 179, 68th Cong., 1st Sess., p. 21.

made under and pursuant to that instrument for a period of thirty-eight years, including the tax period here involved. In fact and in law that instrument controlled the distribution of the trust income.

If we are correct in the position that distribution was controlled by the deed of trust, there is no necessity to consider the question whether the situation calls for the application of State or Federal law. The fact that the income was received by virtue of the instrument creating the trust and retained throughout the balance of the lifetime of respondent's decedent and thereafter until 1928 (with the exception of a relatively small unidentified portion restored to the trustee at an unspecified date in 1928 or later) is believed to decisively determine the question presented in favor of the petitioner. We do not believe it can be seriously contended that the amounts involved were not income in their entirety when received. This question was in effect settled as to this respondent by the decision of the Board of Tax Appeals in *Louise P. V. Whitcomb, supra,* from which no appeal was taken, considered together with the decision in *Marguerite T. Whitcomb, supra,* in which the Government's position was upheld by the Court of Appeals of the District of Columbia.[2] However, it is anticipated

[2] The question, thus limited, can scarcely be said to be an open one. The courts have repeatedly recognized that the beneficiary is taxable upon the full amount of income actu-

that the respondent will rely upon the supposed power of the orders entered by the state probate court in 1928 to retroactively change the taxable status of the income already distributed and attention will next be directed to questions presented by that view of the case.

II

The record discloses that there was no actual change in possession of all or a substantial portion of the income in question and no bona fide intention to restore the same to the trustee

In the objections filed to the trustee's account by the remaindermen it is alleged that an aggregate amount of $622,434.11 was improperly distributed which should have been retained by the trustee on account of depreciation reserve. The contest which followed the filing of the trustee's account was a "contest" in name only. The facts already recited suffice to demonstrate that it was nothing more than a friendly settlement. The account as filed covered the period from 1903 to 1928. The account was filed on September 5, 1928 (R. 38),

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ally received by or distributable to him during the year, without deduction for depreciation sustained by the corpus of the trust. *Codman* v. *Miles*, 28 F. (2d) 823 (C. C. A. 4th), certiorari denied, 278 U. S. 654; *Kaufman* v. *Commissioner*, 44 F. (2d) 144 (C. C. A. 3d); *Hubbell* v. *Burnet*, 46 F. (2d) 446 (C. C. A. 8th), certiorari denied, 283 U. S. 840; *Codman* v. *Commissioner*, 50 F. (2d) 763 (C. C. A. 1st); *Roxburghe* v. *Burnet*, 58 F. (2d) 693 (App. D. C.), certiorari denied, May 31, 1932; *Mary Roxburghe* v. *The United States*, 64 Ct. Cls. 223, certiorari denied, 278 U. S. 598. This is also the clear import of *Baltzell* v. *Mitchell*, 3 F. (2d) 428 (C. C. A. 1st), certiorari denied, 268 U. S. 690, and *Abell* v. *Tait*, 30 F. (2d) 54 (C. C. A. 4th).

and the second day thereafter objections were filed on behalf of the two remaindermen residing in France (R. 140). The exceptions were directed solely to the years 1913 to 1927—*the income-tax years.* Answer to the exceptions was filed on or about September 11th (R. 133–135) and the original and amended orders settling the account were both entered on September 19, 1928 (R. 136–139; 140–144). The rapidity with which the proceeding moved, the fact that the objections were restricted to those years in which income taxes were a factor, the evident absence of any real controversy, the peculiar character of the notes given by or on behalf of the beneficiaries other than respondent's decedent, and the fact that the entire proceeding took place *after* the decision in *Whitcomb* v. *Blair, supra,* are all elements of significance. While they may not indicate collusion—and we do not charge that they do—they may collectively give rise to a not unreasonable inference that the proceeding in the state probate court was dictated by the desire to avoid the consequences of the decision of the Court of Appeals in *Whitcomb* v. *Blair* and the associated decisions of the Board of Tax Appeals referred to hereinabove. Whether, under the circumstances, such an inference is to be drawn, we leave to the Court.

The state probate court adopted in its orders the amounts claimed by the remaindermen to have been improperly distributed. We have prepared a tab-

ulation showing the total sums distributed to life beneficiaries, together with the amounts received by or on behalf of respondent's decedent and the amounts subject to repayment under the court orders, which is incorporated in an appendix to this brief.

Reference to this tabulation discloses that respondent's decedent and her estate received $151,553.63 during the years 1913 to 1926, inclusive, which by virtue of the orders of the probate court was repayable to the trustee on acount of depreciation reserve. The record shows that of this sum "A payment of $10,700 (approximately 7 per cent of the amount due) has been made to the trust" by the estate of respondent's decedent. (R. 42.) The evidence throws no light upon the year or years to which the above payment is to be attributed. Logically it would seem reasonable to apply it against the earlier years first in which event it would have been absorbed many years before the taxable period. No notes or other obligations evidence even a simulated intention to repay the remaining 93 per cent. However, for reasons set forth elsewhere in this brief, we deem the matter of compliance or noncompliance with the orders of the probate court immaterial to a proper disposition of this appeal.

III

The question presented is one of general law arising under a Federal revenue statute as to which the Federal courts are free to exercise their independent judgment

When Section 219 (a) (4) of the Revenue Act of 1921, *supra,* is read in connection with the accompanying subsections, as it of course must be, it requires the inclusion for tax purposes of the income of beneficiaries distributable periodically pursuant to the instrument governing distribution or pursuant to the order governing distribution as the court may direct. What is the amount distributable pursuant to the instrument governing distribution in this case? Consideration of this question must be preceded by the consideration of another—is the question one of general law with reference to which the Federal court is free to exercise its independent judgment or is it one wherein the court is bound by local law? This question is believed susceptible of a ready answer.

An early leading case in which the Supreme Court considered the effect to be given the decisions of State courts is that of *Swift* v. *Tyson,* 16 Pet. 1. The 34th Section of the Judiciary Act of 1789, c. 20, 1 Stat. 73, 92, provided that the laws of the several states, when not in conflict with the Federal Constitution, treaties, or statutes, should be regarded as rules of decision in trials at common law in the United States courts, in cases where they applied. It was contended that by force of

this provision the Federal courts were required to follow the decisions of State tribunals in all cases to which they applied. The Supreme Court, speaking through Mr. Justice Story, declined to subscribe to this view, saying in part (pp. 18–19):

> In all the various cases, which have hitherto come before us for decision, this Court have uniformly supposed that the true interpretation of the thirty-fourth section limited its application to state laws strictly local, that is to say, to the positive statutes of the state, and the construction thereof adopted by the local tribunals, and to rights and titles to things having a permanent locality, such as the rights and titles to real estate, and other matters immovable and intraterritorial in their nature and character. It never has been supposed by us that the section did apply, or was designed to apply, to questions of a more general nature, not at all dependent upon local statutes or local usages of a fixed and permanent operation, as, for example, to the construction of ordinary contracts or other written instruments, and especially to questions of general commercial law, where the state tribunals are called upon to perform the like functions as ourselves, that is, to ascertain upon general reasoning and legal analogies what is the true exposition of the contract or instrument, or what is the just rule furnished by the principles of commercial law to govern the case. And we have not now the slightest difficulty in holding that this section, upon its true intend-

> ment and construction, is strictly limited to local statutes and local usages of the character before stated, and does not extend to contracts and other instruments of a commercial nature, the true interpretation and effect whereof are to be sought, not in the decisions of the local tribunals, but in the general principles and doctrines of commercial jurisprudence. Undoubtedly the decisions of the local tribunals upon such subjects are entitled to, and will receive, the most deliberate attention and respect of this Court; but they can not furnish positive rules, or conclusive authority, by which our own judgments are to be bound up and governed. * * *

In *Lane* v. *Vick,* 3 How. 463, the Court was obliged to construe a will which had been the subject of earlier interpretation by the Supreme Court of Mississippi. The construction adopted by the State court was urged to be binding upon the Federal court. The Supreme Court rejected this contention, saying (p. 476):

> With the greatest respect, it may be proper to say that this court do not follow the state courts in their construction of a will or any other instrument as they do in the construction of statutes.

Lane v. *Vick, supra,* was decided by divided court, but any doubt as to the authority to be accorded the majority opinion is dispelled by later decisions of the same court.

The earlier decision in *Swift* v. *Tyson, supra,* was approved and applied in *Oates* v. *National*

Bank, 100 U. S. 239, 246, and *Railroad Co.* v. *National Bank,* 102 U. S. 14, under somewhat similar circumstances.

A rather enlightening discussion of the subject occurs in *Burgess* v. *Seligman,* 107 U. S. 20. In that case, which involved the construction of a Missouri statute exempting certain classes of stockholders from liability for corporate debts upon dissolution, the Supreme Court of Missouri, after the Federal circuit court had decided the case, made a contrary decision against the same stockholders at the suit of another plaintiff, holding that the defendants did not come within the exempting clause of the statute. The Supreme Court refused to be bound by the State court's decision. We quote from its opinion as follows (pp. 33–34):

> We do not consider ourselves bound to follow the decision of the State court in this case. When the transactions in controversy occurred, and when the case was under the consideration of the Circuit Court, no construction of the statute had been given by the State tribunals contrary to that given by the Circuit Court. The Federal courts have an independent jurisdiction in the administration of State laws, coordinate with, and not subordinate to, that of the State courts, and are bound to exercise their own judgment as to the meaning and effect of those laws. The existence of two coordinate jurisdictions in the same territory is peculiar, and the results would be anomalous and in-

convenient but for the exercise of mutual respect and deference. Since the ordinary administration of the law is carried on by the State courts, it necessarily happens that by the course of their decisions certain rules are established which become rules of property and action in the State, and have all the effect of law, and which it would be wrong to disturb. This is especially true with regard to the law of real estate and the construction of State constitutions and statutes. Such established rules are always regarded by the Federal courts, no less than by the State courts themselves, as authoritative declarations of what the law is. But where the law has not been thus settled it is the right and duty of the Federal courts to exercise their own judgment, as they also always do in reference to the doctrines of commercial law and general jurisprudence. So when contracts and transactions have been entered into, and rights have accrued thereon under a particular state of the decisions, or when there has been no decision of the State tribunals, the Federal courts properly claim the right to adopt their own interpretation of the law applicable to the case, although a different interpretation may be adopted by the State courts after such rights have accrued. But even in such cases, for the sake of harmony and to avoid confusion, the Federal courts will lean toward an agreement of views with the State courts if the question seems to them balanced with doubt. Acting on these principles, founded

> as they are on comity and good sense, the courts of the United States, without sacrificing their own dignity as independent tribunals, endeavor to avoid, and in most cases do avoid, any unseemly conflict with the well-considered decisions of the State courts. As, however, the very object of giving to the national courts jurisdiction to administer the laws of the States in controversies between citizens of different States was to institute independent tribunals which it might be supposed would be unaffected by local prejudices and sectional views, it would be a dereliction of their duty not to exercise an independent judgment in cases not foreclosed by previous adjudication. * * *

The situations in which the Federal courts will adopt as controlling the State court decisions are discussed in *Bucher* v. *Cheshire Railroad Co.,* 125 U. S. 555, and are aptly summarized in the third syllabus of the reported case as follows (p. 555):

> The courts of the United States adopt and follow the decisions of the highest court of a State in questions which concern merely the constitution or laws of that State; also where a course of those decisions, whether founded on statutes or not, have become rules of property within the State; also in regard to rules of evidence in actions at law; and also in reference to the common law of the State, and its laws and customs of a local character, when established by repeated decisions.

Barber v. *Pittsburgh, Fort Wayne and Chicago Ry. Co.,* 166 U. S. 83, related to the construction of a will which had previously been interpreted by the Supreme Court of Pennsylvania. The court thus states the question presented (p. 99):

> Whether the opinion of the Supreme Court of the State in the former action is conclusive evidence of the law of Pennsylvania in a court of the United States depends upon the further question whether the opinion is declaratory of the settled law of Pennsylvania as to the effect of such devises, or is a decision upon the construction of this particular devise.

The court then disposed of the question, stating that although a construction of certain words in deeds or wills of real estate which has become a settled rule of property in a State may be followed by the Federal courts in determining title to land within the State, nevertheless a single decision of the highest State court upon the construction of the words of a particular devise is not conclusive evidence of the State law in a case in the Federal courts involving the construction of the same or like words between other parties or even between the same parties or their privies unless presented under such circumstances as to constitute an adjudication of their rights.

The principles above discussed are reviewed by the Supreme Court in *Kuhn* v. *Fairmont Coal Co.,* 215 U. S. 349. There the Court recognized that,

although the construction of a statute by the Supreme Court of a State may be followed with reference to the interests it may affect or the parties to the suit in which its construction is involved, the mere construction of a will or contract by a State court will not be adopted as conclusive unless it has been settled by the highest court of the State and has been so long acquiesced in as to constitute a rule of property. Where neither of these situations is presented, the court conceives that the Federal tribunal is in duty bound to exercise its own independent judgment as it always does when the case before it depends upon the doctrines of commercial law or general jurisprudence.

The principles of several of the cases above discussed were reiterated and applied by this Court in *Bancroft* v. *Hambly,* 94 Fed. 975. See also *Black & White Taxicab Co.* v. *Brown & Yellow Taxicab Co.,* 276 U. S. 518; *Messinger* v. *Anderson,* 171 Fed. 785 (C. C. A. 6th); and *Cole* v. *Pennsylvania R. Co.,* 43 F. (2d) 953 (C. C. A. 2d).

It seems abundantly clear in the light of the preceding discussion that the orders of the probate court in the present case would not be conclusive upon this Court. The question is one arising under a Federal statute, namely, a revenue act. While it depends upon the construction of the deed of trust executed by A. C. Whitcomb, there is nothing in the entire record to indicate the existence and applicability of any settled rule of property established by repeated decisions of the highest

State court before the rights of the parties accrued. Obviously, this is simply a case of a particular instrument to be construed as to which the Federal court would not only be permitted but in duty bound to exercise its own independent judgment.

IV

Even if it be conceded for the purpose of argument that local law should control, nevertheless the orders of the State court could not under the circumstances of this case retroactively change the taxable status of distributions already made

The trust instrument, as already noted, was executed in 1889 and presumably went into effect at or about that time. Under its terms the trustee distributed the full amount of the net income accruing without reference to a depreciation reserve for a period of approximately 38 years. Two years after the last distribution was made to the estate of the respondent's decedent the court orders were entered in a friendly settlement of the trustee's account. Although the suit may not have been collusive, it was certainly an uncontested one. A judgment entered in such a suit is a *pro forma* determination which should not be binding upon Federal courts. *Fidelity & Columbia Trust Co.* v. *Lucas,* 52 F. (2d) 298 (W. D. Ky.), and *Ford* v. *Commissioner,* 51 F. (2d) 200. Even if our views with respect to the absence of controlling effect of the State law are incorrect, nevertheless it is perfectly clear that the right to taxes had accrued in the Federal Government long before the State court

announced its conclusion which is sought to control the rights of the Federal Government. It seems obvious that the decision of a State court can not divest parties of rights which have previously accrued under a Federal statute, and certainly there is ample authority to support this conclusion. *Burgess* v. *Seligman, supra* (p. 35); *Anderson* v. *Santa Anna,* 116 U. S. 356; *Great Southern Fire Proof Hotel Co.* v. *Jones,* 193 U. S. 532; *Kuhn* v. *Fairmont Coal Co., supra* (p. 360); *Fidelity & Columbia Trust Co.* v. *Lucas, supra.* No reason is apparent why the sovereign should not be entitled to the benefit of the rule just as well as its subjects.

The case last cited related to the construction of a will and the fact background is so similar to that presented by this record that we venture to quote at some length from the opinion of the court (p. 301):

> At the very threshold of this inquiry, however, I am met with the contention of the plaintiff that this court is not free to exercise its independent judgment in construing the will, but that I am conclusively bound by the construction thereof made by the Jefferson circuit court in its judgment of June 11, 1927. While I recognize that as a general rule the decree of a state court, as to the meaning and effect of a will of one of that state's residents, is binding upon the federal court, I do not think that rule has any application under the facts disclosed by this record. I am satisfied that the judgment

relied upon must be regarded as nothing more than an agreed judgment. No other construction of the will than that contended for by the plaintiff was suggested to the commissioner in that case, and when the commissioner's report was filed, the plaintiff, as trustee, and the three children, each of whom was then of age, asked the court to adopt the commissioner's report, including his construction of the will. This the court did, by its judgment entered on the same day. The court in this judgment was careful to point out that the trustee and the three children had each entered a motion that the report be approved, and that they were the only parties interested in the estate. The obvious deduction is that the circuit court did the very natural thing of adopting the commissioner's report, when all the interested parties were present and asking that it be adopted. The government was not represented in the proceeding, although the trustee and the three children each knew that the government was contending for an entirely different construction of the will, and, on the strength of that contention, has already assessed taxes against the trustee of the L. P. Ewald estate in large amounts for each of the years from 1917 to 1924, both inclusive, and had enforced payment thereof; and they knew that the trustee was demanding a refund of these taxes based upon the construction of the will which they were asking the circuit court to adopt. They likewise knew that a similar assessment would

be made by the government for the years 1925 and 1926. So far as this record shows, the controversy between the government and the trustee as to the construction of the will was in no way brought to the attention of the circuit court.

Under these circumstances it would shock one's sense of justice to hold that the government is concluded by the state court judgment. *Furthermore, it is well settled that a decision of a state court, establishing a local rule of property or, construing a state statute or a contract made after the rights of a litigant in a federal court suit had accrued, and in a case to which he was not a party, is not binding upon the federal court.* I know of no reason why this rule should not apply to the construction of wills. See *Kuhn* v. *Fairmont Coal Co.,* 215 U. S. 349, and authorities cited.

I therefore conclude that I am not only free, but it is my duty, to make my own construction of the will in this case. (Italics supplied.)

The facts in this case also bear a strong resemblance to those in *Ford* v. *Commissioner, supra,* a decision by the Circuit Court of Appeals for the Sixth Circuit. There the executors of an estate which consisted mostly of stocks made a partial distribution in 1920 of the stocks and the legatees received the dividends therefrom in 1922. The probate court in 1926 held the distribution to be premature and ordered the legatees to account for

the principal and income of the stock from the date of distribution up to December 31, 1922. The matter was handled entirely by book entries. The court said (p. 207):

> In fact, the petitioners who received the 1921 and 1922 dividends never paid back any part thereof, and the income taxes for both years, based on the receipt of these dividends, were paid by the petitioners. * * *
>
> We think these 1922 dividends were taxable income received by the petitioners during that year. Certainly they then had complete legal title to the stock and to the dividends. *If taxes regularly assessed could be invalidated, an indefinite number of years later, by a consent judgment purporting to vacate the title of the taxpayer to the fund he had reported as income, the necessary system of tax collection would be much impaired. The true normal criterion to be applied in this class of case is the actual receipt and retention during the year in question of what was then considered to be income, not whether the taxpayer exposed himself to possible personal liability.*
>
> If it were to be conceded that a taxpayer who, before making his return, or perhaps even later, discovers that what he thought was income was improperly paid to him, and who must and does return it, should be relieved from the tax, the concession does not reach a case where the flaw in his title is only a claim of defect, until at a later time it is established, one way or the other, by a court

> judgment. In that respect the case is within the rule applied by the Supreme Court in *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 365, and by this court in *Board* v. *Commissioner,* 51 F. (2d) 73, decided June 11, 1931. Neither would the concession reach a case where the taxpayer did not repay or give up the income, but only permitted it to be charged against himself as a matter of bookkeeping, knowing that his counter equities were such that the charge against him would be uncollectible. (Italics supplied.)

It is to be remembered that the respondent's decedent and her estate received and retained the entire income distributable to her under the trust during the taxable period involved. It is true that $10,700 has been repaid to the trustee by respondent (R. 65–66), but it does not appear to what year or years this payment relates or when it was made. Even if it did appear, it would be a reason for reducing the income of the year of payment rather than for making a retroactive change in the amount of respondent's net income for the earlier taxable years. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359.

If this Court approves the majority decision of the Board of Tax Appeals it will in effect sanction the doctrine that a State court can divest parties of rights previously accrued under a Federal statute. The practical result of applying such a doctrine in the administration and collection of the Federal